Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Review of the Commission's Rules Regarding The Pricing of Unbundled Network Elements And the Resale of Service by Incumbent Local Exchange Carriers	)	WC Docket No. 03-173

COMMENTS OF THE IOWA UTILITIES BOARD

I. INTRODUCTION

On September 15, 2003, the Federal Communications Commission (FCC) issued a Notice of Proposed Rulemaking (NOPR), Docket No. 03-173, to review its rules regarding the pricing of unbundled network elements (UNEs) and resale services by incumbent local exchange carriers (ILECs). This review of the FCC's rules is intended to be the first comprehensive assessment of rules adopted in 1996, following the implementation of the Telecommunications Act of 1996 (Act). The Iowa Utilities Board (IUB) agrees with the FCC that rules as important as these should be reviewed periodically. However, the FCC's effort thus far seems to be a solution in search of a problem. That is, the FCC seems to be considering adjustments to its UNE costing methodology aimed at increasing current UNE rates, based on an unsubstantiated assumption that UNE rates and their underlying costs are too low. As discussed in the following comments, the FCC's review of UNE rates and their underlying costing methodology and inputs should take a more open-minded approach.

II. DISCUSSION

A. GENERAL THEORY

The FCC's total element long-run incremental cost (TELRIC) methodology was developed to simulate a competitive market outcome and promote the development of competition in local telecommunications markets, as required by the Act. The Act recognized that with current technologies the public interest could best be served by moving from a monopoly environment to a competitive marketplace for local service. This goal must not be ignored when reviewing TELRIC and resulting UNE rates.

Access to UNEs at reasonable, cost-based rates plays an important role in developing competitive local service markets. It allows both large and small competitive local exchange carriers (CLECs) the opportunity to enter the market and establish a customer base while deploying their own facilities. Competition would develop much more slowly if CLECs had to rely solely on their own facilities.

In theory, UNE rates based on TELRIC send proper price signals that encourage market participants to make economically efficient investment decisions as the competitive marketplace develops. Proper price signals will tell CLECs whether they should build their own facilities to serve a customer or purchase UNE facilities from the ILEC. If UNE cost estimates and resulting rates are too high, the CLEC will build new facilities when it would have been more economically efficient to purchase the ILEC's UNE facilities. If the rates are too low, the opposite will occur. Also, UNE rates that are too low will not provide ILECs sufficient incentive to build new facilities, by not permitting them to recover their investment in facilities used by the CLECs.

In its NOPR, the FCC notes that its UNE costing and pricing rules were adopted several years ago. The FCC proposes a review of the rules to determine whether its TELRIC methodology is encouraging efficient facilities investment as intended (paragraph 3). The FCC suggests that if the rules are not working as intended, the methodology and resulting UNE rates should be changed.

However, the FCC's review seems to begin with an implicit, unsubstantiated assumption that UNE cost estimates and rates are too low,

causing both ILECs and CLECs to avoid investing in their respective systems and, thus, slowing the development of facilities-based competition.

The FCC suggests that competition has caused some of the market fundamentals to change, implying that the degree of competition experienced thus far has not met FCC expectations. However, while effective facilities-based competition is the goal, it is not clear that any slowdowns or delays exist or that they are being caused by UNE pricing. Rather, any problems may be those common to the entire industry, including the recent general economic downturn. Without substantial evidence, the FCC should not assume there are problems with UNE rates solely because CLECs base a portion of their business on UNEs, or because ILECs claim that UNE rates are too low to provide a sufficient return on new investment. There are several potential reasons that could explain a reduction in investment levels. One obvious reason seems to be the current low growth in demand for wireline telecommunications services in general. Investment levels are usually flat or declining in industries with slow or nonexistent growth. Thus, it should come as no surprise to find flat or decreasing investment levels in wireline-based local telecommunications markets.

The FCC is also concerned that the current TELRIC methodology and UNE ratemaking process may be too cumbersome and, depending on how the TELRIC principles are interpreted and applied, produce too much variation in UNE rates. They suggest a need for simplifying the process for all participants, including state commissions, and minimizing uncertainty about application of the rules (paragraph 6). The FCC links this need for simplification to the "excessively hypothetical nature of the TELRIC inquiry." That is, because the FCC's TELRIC methodology assumes system-wide application of the most efficient, least-cost technology, it ignores real-world attributes of the existing system. However, the FCC's concern with real-world attributes in TELRIC modeling seems more focused on ILEC cost recovery than sending proper price signals. Although cost recovery is a valid concern, the FCC should maintain its focus on providing proper price signals to promote efficient and effective competition. Properly designed price signals will not conflict with cost recovery.

The IUB supports making adjustments to TELRIC methodology to reflect real-world attributes of the ILEC's network, for the primary purpose of providing proper price signals to promote efficient and effective facilities-based competition. As more fully explained in its remaining comments, the IUB believes that state commissions are in the best position to determine the appropriate adjustments, based on state-specific evidence presented in UNE pricing proceedings.

B. NETWORK INPUTS

The FCC asks state commissions for comment on whether they have adopted cost models capable of reflecting existing network routing (paragraph 66). The IUB believes it has. In its UNE pricing case for Qwest Corporation (Qwest), the IUB adopted results from a TELRIC-based model proposed by CLEC intervenors (the Hatfield Model), adjusted to reflect real-world characteristics of Qwest's Iowa network according to evidence presented in the case.[1]

The FCC raises several questions regarding fill factors (paragraphs 73-75), once again stating its concern about the use of an overly hypothetical methodology without reference to real-world attributes. The use of existing fill factors instead of forward-looking factors based on current demand may have the effect of increasing estimated costs. Because of their use throughout the cost models, assumed fill factor levels will have far reaching consequences in cost estimates and resulting UNE rates. Therefore, the FCC ought to avoid imposing strict guidelines on the use of fill factors and should, instead, rely on the state commissions to properly evaluate the real-world attributes of their own jurisdictions and include these in their fill factor calculations. Although the establishment of strict fill factor guidelines might reduce the variation in state cost estimates, they would likely conflict with the FCC's stated goal of recognizing real-world attributes of ILEC networks.

[1] Docket No. RPU-96-9, US West Communications, Inc. (n/k/a Qwest Corporation), *Final Decision and Order*, 4/23/98.

C. COST OF CAPITAL

The FCC raises several questions regarding cost of capital estimation and its use in developing specific rates (paragraphs 82-91). Specifically, the FCC seeks comment on how the cost of capital should be determined, how competition or the threat of competition should be factored into the estimate, and whether there should be separate cost of capital estimates for individual UNEs or groups. In each instance, the FCC should rely on the state commissions to determine the appropriate cost of capital used in estimating costs. The FCC should also rely on state commissions to determine whether it is appropriate to establish separate costs of capital for individual UNEs or groups. As pointed out in the FCC's order (paragraph 90), no state has adopted separate costs of capital for individual UNEs. State commissions are in the best position to make this determination, and to estimate any UNE-specific costs of capital. State commissions have been determining the cost of capital for local telecommunications companies over several decades and are in a better position than the FCC to evaluate the relevant factors, including competitive conditions and overall risk, specific to their jurisdictions.

D. DEPRECIATION EXPENSE

The FCC has posed many questions and proposals regarding depreciation expense. Most of them suggest that the FCC believes the current estimates are too low, causing ILECs to subsidize their competitors. The FCC focuses on two components of depreciation: the useful life of the asset, and the rate at which the asset is depreciated. Regarding depreciation rates, the FCC proposes that an ILEC should be allowed to use accelerated rates, recovering more depreciation expense in the early years of an asset's life and less in later years, thereby allowing the ILEC to compete with CLECs that have purchased newer, lower-priced equipment (paragraph 93).

This approach might produce the opposite effect, however, and impede rather than promote competition. Accelerating ILEC depreciation rates would increase TELRIC cost estimates and resulting UNE rates, which might make it

unduly more difficult for CLECs to engage in UNE-based competition. In later years, when the ILEC's depreciation expenses are much lower, it would give the ILEC a potentially unfair competitive advantage due to its lower expenses (made lower than they otherwise would have been under more levelized depreciation rates). Under such a scenario, the ILEC would receive an unfair advantage at both ends of the asset's life. If the FCC is going to seriously consider such a proposal, it should do so carefully. The potential impact on the developing marketplace could have far reaching consequences.

E. NON-RECURRING COSTS

Non-recurring costs, like other expenses, should be collected from cost causers in a manner that closely reflects the way in which the costs are incurred on a forward-looking basis, without posing an undue barrier to entry. If fixed entry costs are too high, CLECs either will not enter the market or not expand their customer bases as quickly as they would otherwise. ILECs should be allowed to recover their costs, but should not be allowed to use the recovery of non-recurring costs as a competitive weapon.

F. RATE CHANGES OVER TIME

The FCC is considering whether to make factored adjustments to UNE rates on a periodic basis, to avoid the need for full UNE pricing proceedings every few years. The FCC's example method uses an inflation factor and productivity factor similar to those used in price cap regimes. Market participants and the investment community typically view simplicity and predictability in a positive light. Thus, the use of factor mechanisms to adjust rates over time is an option that should be reviewed.

The FCC should not, however, impose a single factor or mechanism on all states. Just as the state commissions should be allowed to determine costs and set their own UNE rates independently, they should also be allowed to determine appropriate adjustment factors and levels based upon the particular circumstances in each state.

G. RATE DE-AVERAGING

The FCC asks whether it should continue its requirement for geographic UNE rate de-averaging (paragraph 136). If the FCC were to order the re-averaging of UNE rates, the IUB might consider re-averaging Qwest's business retail rates to facilitate competition in the lower cost zone and prevent arbitrage distortions in the higher cost zone.

In Qwest's UNE de-averaging case, the IUB de-averaged Qwest's UNE loop costs across three geographic pricing zones.[2] Wire centers were assigned to the three zones according to average loop costs, as determined by the same Hatfield Model used in Qwest's UNE pricing case. The IUB also examined the need to de-average Qwest's retail rates at the same time it de-averaged its UNE rates.

Qwest's Iowa retail rates are significantly differentiated by customer class (residential and business). Because of these class differences, and the fact that Qwest's Iowa embedded costs are lower than its forward-looking costs, Qwest's residential retail rates remained lower than its UNE loop rates, even after UNE de-averaging. Thus, there was no practical reason to de-average residential retail rates. It was different for business rates, which were higher than the average UNE loop rate. Therefore, the IUB de-averaged business retail rates in order to facilitate UNE-based business competition in the higher cost zone and prevent loss of retail revenue through arbitrage distortions in the lower cost zone. Given the significant difference between Iowa embedded and forward-looking costs, it is not clear that eliminating class differences between residential and business rates would be sufficient to facilitate UNE-based residential competition.

H. RESALE PRICING

The FCC asks whether it should provide the states detailed guidelines for determining the actual avoided costs to be used in setting resale rate discounts (paragraphs 143-145). The IUB does not require any further guidance from the FCC in defining or determining avoided costs for resold retail services. For

[2] Docket No. RPU-00-1, Qwest Corporation, *Final Decision and Order*, 1/11/01.

example, in Qwest's UNE pricing case, the IUB established discounted resale rates for Qwest retail services according to costs that would actually be avoided by Qwest. The discounts were based on Iowa-specific cost evidence presented in the case.

The FCC also asks whether it should revisit the question of whether the Subscriber Line Charge (SLC) should be subject to resale discount (paragraph 146). In determining Qwest's resale rates, the IUB did not include any interstate charges in its avoided cost estimates since the Act did not give the IUB jurisdiction over interstate costs or rates, or the separations process. Given that the Act has not changed on this point, the IUB believes the FCC should maintain its previous position and continue to exclude the SLC from retail discounts.

III. CONCLUSION

The FCC's focus on TELRIC and UNE pricing methodology in this NOPR is appropriate because these pricing tools are important to the development of competition and should be reviewed periodically. However, the FCC should not approach this review with the presumption that the methodology needs major revision. The FCC should retain the goal of developing competition through proper price signals. It should not push this goal into a secondary role as it focuses on cost recovery for ILECs. ILEC cost recovery is a valid concern and, if necessary, the FCC should address the issue. But the focus should remain on developing UNE rates that provide CLECs proper, economically efficient price signals on whether to purchase UNEs or build their own facilities. Economically efficient UNE rates that send proper price signals will, by definition, also provide ILECs full cost recovery. Competition is growing. It may not be the type of competition some envisioned or at rates others had hoped for, but it is growing. Any changes in TELRIC and UNE rates, particularly major ones, should be made with great care.

The FCC is placing considerable emphasis on the real-world attributes of ILEC systems. The approach of blending theoretical costing methodologies with real-world adjustments is something the IUB has already implemented in Qwest's UNE pricing case. The IUB believes that state commissions are best suited to

determine the real-world attributes of their own jurisdictions. They have a unique perspective on the systems that are in place, the developing trends, and the risks to incumbents and new entrants. The states, not the FCC, should determine the cost estimates and resulting UNE rates. The FCC ought to provide guidelines to the states, but these should not be restrictive to the point that real-world attributes of local telephone competition cannot be incorporated by the very entities most capable of doing so.